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IN THE

Supreme Court of the United States

OCTOBER TERM 1946.

No. 330

CROSSETT WESTERN COMPANY, *Petitioner,*

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT, AND BRIEF IN SUPPORT OF PETITION.

CROSSETT WESTERN COMPANY,
Petitioner.

By CARL E. DAVIDSON,
Counsel for Petitioner.

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Petition to the Honorable, the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

The above named petitioner prays that a writ of certiorari issue to the United States Circuit Court of Appeals for the Third Circuit to review the judgment and decree of that court (R. 40) entered on April 26, 1945 affirming a decision of the Tax Court of the United States which had held that petitioner was liable for deficiencies in Federal Excess Profits Taxes for the calendar years 1940 and 1941.

JURISDICTION.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended (28 U. S. C. A. par. 347(a)).

THE OPINIONS OF THE COURTS BELOW.

The opinion of the Tax Court (R. 21a) is reported at 4 T. C. 783. The opinion of the Circuit Court of Appeals for the Third Circuit is printed in the record beginning at page 32.

STATUTES AND REGULATIONS INVOLVED.

The relevant provisions of the Internal Revenue Code are contained in Section 718, particularly subsections (a)(2), (a)(4) and (b)(3) thereof, and section 751. These sections are set forth in the Appendix at pages 23 to 29.

The regulations are Section 30.718-5, Regulations 109, approved February 8, 1941, and Section 30.718-6, added October, 1941. The relevant portions thereof are set forth in the Appendix beginning at page 29.

SUMMARY STATEMENT OF MATTER INVOLVED.

Petitioner is a corporation which in 1923 issued all its capital stock for the assets of three other corporations. The assets were received without recognition of gain or loss under the Internal Revenue Law and the bases of the assets in the hands of the petitioner were the same as the bases of the assets in the hands of the transferors. The net unadjusted basis of all assets acquired after deducting liabilities assumed was $3,644,389.48 which was $923,180.51 in excess of the original investment by the transferors' stockholders in the transferor corporations. Two of the three transferors had accumulated earnings and profits at the time aggregating $923,180.51. From the start of petitioner's business through December 31, 1939 its losses exceeded $923,180.51.

In computing its equity invested capital for the purpose of its 1940 and 1941 excess profits taxes, the petitioner included its paid-in capital of $3,644,389.48 pursuant to the provisions of subsection (a)(2) of Section 718 and made no deduction on account of the amount of the earnings and profits of the transferor companies. The courts below held that such deduction was required by subsection (b)(3) of Section 718 which provides for reduction of equity invested capital by the amount of "the earnings and profits of a transferor corporation which previously at any time were included in accumulated earnings and profits by reason of" certain transactions.

Petitioner maintains that Section 718 contemplates that each and every corporation, whether or not resulting from a consolidation or other non-recognition reorganization, shall have an invested capital of its own and shall not be treated as a mere continuance of its predecessor predecessors; that the purpose and effect of subsection (b)(3) of Section 718 is simply to prevent the duplication which would result from treating the net basis of assets acquired for stock upon a reorganization as paid-in capital and adding thereto as part of taxpayer's "accumulated earnings and profits as of the beginning of the taxable year" an amount of earnings and profits of the transferor; that the "accumulated earnings and profits" which must be reduced pursuant to subsection (b)(3) are those as of the beginning of the taxable year; and that such subsection (b)(3) has no application where a taxpayer's invested capital computation reflects no "accumulated earnings and profits" as of the beginning of the taxable year. Under this interpretation a "deficit corporation"—one which has lost part of its paid-in capital—such as petitioner, does not have its paid-in capital reduced for invested capital purposes as the result of loss of its capital.

The courts below held that subsection (b)(3) of Section 718 requires reduction of invested capital irrespective of whether any amount of transferor earnings and profits is

included in "accumulated earnings and profits as of the beginning of the taxable year."

QUESTION PRESENTED.

Did the Circuit Court of Appeals err in holding that subsection (b)(3) of Section 718 requires reduction of petitioner's equity invested capital by the amount of its predecessors' earnings and profits despite the fact that no accumulated earnings and profits are included in the invested capital computations for the taxable years?

FACTS.

The facts are set forth in a stipulation and the Tax Court found the facts substantially as stipulated (R. 4a, 21a).

Petitioner is a Delaware corporation which was organized November 19, 1923, pursuant to a plan of reorganization. On or about December 31, 1923, petitioner issued all its capital stock for the assets of three other corporations. The assets were received without recognition of gain or loss under the Internal Revenue Laws and the bases of the assets in the hands of the petitioner were the same as the bases of the assets in the hands of the transferors (R. 4a).

The net unadjusted basis for determining loss of all assets acquired after deducting liabilities assumed was $3,644,389.48, which amount was $923,180.51 in excess of the orginal investment by the transferors' stockholders in the transferor corporations. Two of the three transferor corporations had accumulated earnings and profits at the time of the transfer aggregating $923,180.51 (R. 7a).

Petitioner's operations commenced on January 1, 1924, and from that date to and including December 31, 1939, resulted in aggregate losses in excess of $923,180.51 (R. 8a).

Petitioner made its computation of equity invested in its excess profits tax return for 1940, so far as concerns the question here presented, in exact accordance with respondent's instructions set forth in that return. It included as paid-in capital the entire net basis of the assets originally

paid in for its stock by the three predecessor companies and, as it had no accumulated earnings and profits as of the beginning of the taxable year, it did not deduct any amount on account of predecessor earnings. The invested capital computation in the excess profits tax return for the calendar year 1941 was made on the same basis.

Upon audit of the returns respondent took the position, contrary to his own directions in the 1940 return form, that there should be deducted from the amount of assets paid in for taxpayer's stock an amount equivalent to the predecessors' earnings and profits as of the date of the transfer and asserted deficiencies on such basis.

The Tax Court held that there are deficiencies in petitioner's Excess Profits Tax for the years 1940 and 1941 in the respective amounts of $266.98 and $35,128.18 (R. 31a).

THE DECISIONS BELOW.

The Tax Court held that respondent's second interpretation requiring reduction of equity invested capital by the amount of its predecessors' earnings was correct, holding that the language of subsection (b)(3) is so clear and unambiguous as to preclude resort to the unusually illuminating legislative history establishing, we submit, that respondent's first interpretation was correct. In other words, although respondent had adopted two diametrically opposed interpretations, the Tax Court said that the bare language of subsection (b)(3) must be interpreted without reference to the legislative history.

The Circuit Court of Appeals apparently felt that the legislative history could not properly be ignored, but, we submit, misconstrued that history to be consistent with the view that Congress intended to require a deduction even in the case of a deficit corporation. The opinion recognizes that if the House bill had been passed, the deduction would have been erroneous but in effect ignores the specific statement of the Senate Committee that it had "made no change in the determination of equity invested capital except to

clarify the provisions which were designed to avoid any overstatement of invested capital as the result of duplicating amounts in the items of earnings and profits and property paid in."

REASONS RELIED ON FOR ALLOWANCE OF THIS WRIT.

A writ of certiorari should be issued in this case, it is submitted, because the Circuit Court of Appeals has decided an important question of Federal law which has not been, but should be, settled by this Court. The proper interpretation of the statutory provision dealt with in this case obviously affects the invested capital computation, and therefore the excess profits taxes, of every corporation which as of the beginning of the taxable year had a deficit, i. e., had lost a part of the capital paid in for its stock, which corporation had acquired in a "non-recognition" transaction the assets of another corporation having accumulated earnings and profits.

The question, we earnestly submit, has been erroneously decided and involves the defeat of the clear intention of Congress as shown by the legislative history. The opinion below involves adoption of the theory as to the status of paid-in capital in cases of tax free reorganizations rejected by Congress for invested capital computation purposes.

While petitioner is unable to present direct evidence as to the number of taxpayers affected by the question here presented, it is suggested that the Court might call upon respondent to verify or deny what petitioner understands to be the fact, viz. that the question is presented in the cases of many other taxpayers involving large sums of money. An authoritative determination of the question at this time will, it is believed, avoid much future litigation. The importance of the question is evidenced by the detailed attention given it by the Congressional committees, as shown by the committee reports referred to in the brief attached.

It is submitted that an authoritative decision by this

Court on a question of statutory interpretation of such importance in the administration of the Revenue laws should be made as promptly as practicable and not await ultimate determination at some indefinite time in the future with intervening uncertainty from the standpoint of the Treasury and the taxpayers involved.

The question is an important question which has been wrongly decided and has not been passed upon by this Court. It is highly important in the administration of the excess profits tax laws and should be settled by this Court.

Wherefore, petitioner respectfully prays that a writ of certiorari issue under the seal of this Court to review the decision of the Circuit Court of Appeals for the Third Circuit is the above case.

CROSSETT WESTERN COMPANY,
Petitioner.

By CARL E. DAVIDSON,
Counsel for Petitioner.

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BRIEF IN SUPPORT OF PETITION.

QUESTIONS PRESENTED, STATEMENT OF CASE, STATUTES, ETC.

The statement of the question presented and the statement of the case are set forth in the petition and the statutes involved are set forth in the Appendix attached hereto at pages 23, 24 and 25.

SPECIFICATION OF ERROR.

The Circuit Court of Appeals erred in holding that reduction of petitioner's paid-in capital for invested capital purposes by the amount of its predecessors' earnings is required by subsection (b)(3) of Section 718.

I. The legislative history of Subsection (b)(3) of Section 718 of the Internal Revenue Code shows a clear Congressional intent that invested capital is to be reduced by an amount of predecessor earnings and profits only if and to the extent that such amount is included in accumulated earnings and profits at the beginning of the taxable year.

Although the Circuit Court of Appeals apparently agreed that the Tax Court's action in ignoring the legislative history was incorrect and in its opinion sets forth a survey of that history (R. 35-38), the survey so telescopes that history as to give rise to the erroneous impression that it is consistent with the view that Congress intended that subsection (b)(3) should operate to reduce invested capital of a deficit corporation. The legislative history correctly understood, we submit, clearly shows that the Congressional intent was precisely to the contrary.

Section 718 of the Second Revenue Bill of 1940 (H. R. 10413), containing provisions for determination of invested capital, included, as does Section 718 of the Internal Revenue Code, provisions for inclusion in equity invested capital of assets paid in for stock and of "the accumulated earnings and profits as of the beginning of such taxable year." Subsection (b)(3) of Section 718 first appeared as subsection (c)(4) of this Bill and, as introduced in the House, provided as follows:

> "(c) Rules for application of subsections (a) and (b) for the purposes of subsections (a) and (b) * * *
>
> "(4) Earnings and Profits of Transferor Corporations—For the purposes of subsection (a)(4) the accumulated earnings and profits of the corporation shall be determined without the inclusion of any of the earnings and profits of a transferor corporation which would otherwise be included by reason of property of such transferor having been paid in for shares of, or as a contribution to the capital of, or as paid-in surplus of, the transferee corporation."

In explanation of the necessity for this provision, the House Ways and Means Committee stated as follows:

> "Under various provisions of the Internal Revenue Code dealing with exchanges and liquidations, the transfer of the property by a corporation to another corporation results in the non-recognition, in whole or in part, of the gain or loss realized by the transferor upon such transfer. In such cases well established principles of income tax law require that the earnings and profits of the transferor shall go over to the transferee and shall be considered to be earnings and profits of the transferee for tax purposes. *Subsection (c)(4) of section 718 provides that such transferred earnings and profits shall not be taken into account in computing the earnings and profits as of the beginning of the taxable year* for the purpose of determining the equity invested capital. *Inasmuch as the property received by the transferee upon such a transfer is included in such cases in the equity invested capital at its adjusted basis in the hands of the transferor,* it is necessary to exclude the earnings and profits acquired by the transferee by reason of such transfer in order to avoid duplication." (Italics supplied.)
>
> (Report of House Committee on Ways and Means on Excess Profits Tax Bill of 1940, House Report 2894, Cumulative Bulletin 1940-2, p. 514.)

There is, of course, no doubt that there would have been no reduction of invested capital in the case of deficit corporations had the statute been enacted in the form of the House bill. The court below so conceded in its statement that "if the House proposal of 718(c)(4) * * * had been adopted, the present question might well not have arisen" (R. 37).

The Senate Finance Committee moved the above quoted paragraph (4) of subsection (c) to subsection (b) of Section 18, and changed its number to (b)(3). By such transfer the paragraph became one of the items of "reduction in equity invested capital." The language of the paragraph was changed to read:

"The earnings and profits of a transferor corporation which previously at any time were included in accumulated earnings and profits by reason of property of such transferor having been paid in for shares of, or as a contribution to the capital of, or as paid-in surplus of, the transferee corporation."

(Second Revenue Bill of 1940 as Reported by Senate Finance Committee—Senate Report No. 2114 on H. R. 10413, Cumulative Bulletin 1940-2, pg. 532.)

The Senate Committee thus changed the form of the language under consideration from that of a provision for non-inclusion in determination of "accumulated earnings and profits" to be included in invested capital, to an item of deduction of an amount included in "accumulated earnings and profits." In making this change it was unnecessary to repeat the part of subsection (c)(4) of the House bill reading "for the purposes of subsection (a)(4) the accumulated earnings and profits of the corporation shall be determined without the inclusion of any of." The changed paragraph, therefore, starts with the words "The earnings and profits of a transferor corporation which". In view of the fact that such change involved omission of the antecedent words "accumulated earnings and profits" as appearing in subsection (c)(4), the words "would otherwise be included" were changed to read "previously at any time were included in accumulated earnings and profits." In other words, the location of the words "accumulated earnings and profits" in the sentence was changed. Such a change in location, however, carries no implication that the "accumulated earnings and profits" referred to in subsection (b)(3) were any different accumulated earnings and profits from those referred to in subsection (c)(4). Both provisions refer to the same "accumulated earnings and profits"—those as of the beginning of the taxable year. That this was the purpose of the Senate Finance Committee is established beyond question by the committee's explanation. The committee said:

"Your committee has made *no change* in the determination of equity invested capital except to *clarify the provisions which were designed to avoid any overstatement* of invested capital as the result of *duplicating* amounts in the items of earnings and profits and property paid in. Such a duplication might otherwise arise in the computation of invested capital in cases of reorganization and other tax-free exchanges." (Italics supplied.)

(Senate Report No. 2114, Cumulative Bulletin 1940-2, pp. 528, 532.)

In its detailed explanation of this change in text the Senate Finance Committee in its same report said:

"Section 718. Invested Capital. This section is substantially as it was in the House bill except for certain *clerical* and *technical* changes. The most important of these are as follows:

"(1) Section 718 (c)(4) of the House bill provided that, in making the computations required by subsections (a) and (b), the earnings and profits of a transferee corporation were not to include the earnings and profits of another corporation which would otherwise be included by reason of property of such other corporation having been paid in for stock, or as a contribution to capital, or as paid-in surplus, of the transferee corporation. *This subsection has been inserted as Section 718 (b)(3) and made an actual step in the computation.*" (Italics supplied)

(Cumulative Bulletin 1940-2, pp. 528, 539.)

These committee statements are obviously deceptive if the Senate Finance Committee provision referred to "accumulated earnings and profits" as of a different date from that referred to in the House provision. As illustrated by this case, such a change would not be one of form or technical but would be a drastic change of substance. If the court's decision is correct, the Senate Finance Committee provision changed an item which clearly had a status as paid-in capital, not subject to reduction on account of subsequent

losses, into an item of earnings and profits to be eliminated if the transferee suffered losses.

The conference committee made no change whatever from the Senate bill so far as the language here in issue is concerned, viz., "the earnings and profits of a transferor corporation which previously at any time were included in accumulated earnings and profits" and stated in part:

> "* * * The conference agreement also makes further technical changes in order to eliminate duplications in the computation of equity invested capital. Provisions have been inserted governing the extent to which the equity invested capital of a parent corporation is to be increased or decreased following a liquidation under section 112 (b)(6). This provision enables the provisions of section 718 (b)(3) to be expanded so as to cover all situations in which, under the doctrine of Commissioner v. Sansome (60 Fed. (2d) 931), the earnings and profits of one corporation became the earnings and profits of another."
>
> (House of Representatives Report No. 3002, Cumulative Bulletin 1940-2, pp. 548, 555.)

The opinion of the Circuit Court of Appeals immediately after quoting the above language of the conference committee states:

> "As seen, unquestionably Congress in considering this branch of the excess profits tax problem had in mind possible duplication of equity invested capital. If the House proposal of 718 (c)(4) calling for a reduction of accumulated earnings and profits alone and not providing for a reduction of equity invested capital had been adopted, the present question might well not have arisen. But 718 (c)(4) was deliberately eliminated and in its place 718 (b)(3) was substituted with the Conference Committee reporting as to the latter that it was 'expanded so as to cover all situations in which, under the doctrine of Commissioner v. Sansome (60 F. (2d) 931), the earnings and profits of one corporation become the earnings and profits of another.' It is fair to assume that if Congress had intended the section which

it finally adopted not to apply to such facts as here presented it would have so stated."

The foregoing, we submit, involves a clear misconception of what the committee meant when it used the words "expanded so as to cover all situations in which, under the doctrine of Commissioner v. Sansome (60 Fed. (2d) 931), the earnings and profits of one corporation become the earnings and profits of another." The reference was not to anything in the language of subsection (b)(3) but to other provisions as to the effect of a liquidation under section 112 (b)(6) and the full quotation clearly indicates that what the conference committee had in mind was merely to prevent any *duplication* which might result from the application of the Sansome doctrine. Nothing indicates that the changes made by the Senate committee or the Conference committee were designed to make subsection (b)(3) applicable to deficit corporations, where there is no duplication. We submit therefore that the legislative history does establish that the Congressional intent in enacting subsection (b)(3) was merely to prevent duplications and not to do away with the established rule that paid-in capital is not reduced by subsequent losses in any case.

II. The language of subsection (b)(3) properly interpreted requires reduction of equity invested capital by the amount of predecessor earnings and profits only if and to the extent that such earnings are included in accumulated earnings and profits at the beginning of the taxable year.

Subsection (b)(3) provides for reduction in equity invested capital by the amount of "the earnings and profits of another corporation which previously at any time were included in *accumulated earnings and profits* by reason of" certain transactions.

The controversy here involves the question as to what the expression "accumulated earnings and profits" refers. "Accumulated earnings and profits" *as of what date?* Peti-

tioner maintains that the accumulated earnings referred to are those at the beginning of the taxable year, while the Court held that the accumulated earnings referred to are those as of the date on which the petitioner acquired the assets of another corporation.

Petitioner maintains the statute should be interpreted to mean "The earnings and profits of another corporation which previously at any time were included in accumulated earnings and profits *as of the beginning of the taxable year* by reason of" etc.

Petitioner insists that the word "*accumulated*" appearing in this provision of the statute cannot be ignored or deleted; that when the phrase "accumulated earnings and profits" is used, it must have reference to a particular date.

The word "accumulated" means "amassed." The word "accumulated" can refer only to a particular date. The expression "earnings and profits" simply describes the excess of gains over losses and we properly speak of "earnings and profits" for a specified period or of "accumulated earnings and profits" *as of a particular date.*

Since the provision is one for deduction of an item included in accumulated earnings and profits and is contained in a section of the statute providing for addition of "accumulated earnings and profits" as of the beginning of the taxable year, and the phrase "accumulated earnings and profits" necessarily speaks as of some particular date, the logical assumption is that the date intended is the same both with respect to the item of accumulated earnings and profits, to be added, and the item "included in" accumulated earnings and profits, to be deducted.

This interpretation does not involve deletion of the words "previously at any time." These words are a necessary part of a clause designed to make sure that no amount of earnings and profits of another corporation should be included in invested capital as a part of "accumulated earnings and profits" at the beginning of the taxable year because that amount is already included as paid in capital. The clause is "which previously at any time were included."

The word "included" properly may be used as equivalent to "comprehended," or "embraced." In *Helvering* v. *Morgan's, Inc.*, 293 U. S. 121, 55 S. Ct. 60, the court defined the word "includes" as being equivalent to "comprehends" or "embraces." Webster's New International Dictionary, Second Edition, defines "included" as meaning "enclosed," "confined," "embraced."

It is therefore quite clear that the provision should be read as "the earnings and profits of another corporation which previously at any time were *comprehended* in," or as "the earnings and profits of another corporation which previously at any time were *embraced* in," accumulated earnings and profits.

The words "previously at any time" show that if an amount of earnings and profits of a predecessor was at any time "comprehended" in or "embraced" in the amount of the accumulated earnings and profits at the beginning of the taxable year, such amount must be deducted to the extent that there are accumulated earnings and profits at the beginning of the taxable year.

The "accumulated earnings and profits" account normally reflects the results of operations of the corporation over the entire period of its existence prior to the particular date; that is, it shows the amount of the excess of the earnings and profits for all prior taxable periods over the losses for all prior taxable periods.

If the words "previously at any time" had been omitted so that the clause read "which were included in," it would still have been possible in certain circumstances for a taxpayer to claim a duplication in invested capital. For example, if in the determination of the amount of accumulated earnings and profits as of the beginning of the taxable year the computation included as part of the petitioner's prior earnings an amount of earnings and profits of a predecessor and treated petitioner's own losses subsequent to the acquisition as chargeable against such amount of predecessor earnings, and after such losses the taxpayer had earnings of its own, the account might reflect "accumulated earnings

and profits" at the beginning of the taxable year merely because the predecessor earnings and profits had thus been embraced within the accumulated earnings and profits at the beginning of the year.

An alternative interpretation of the subsection which equally establishes that there should be no deduction in this case, is that there should be a deduction under the subsection only if and when the taxpayer *included* predecessor earnings and profits in its computation of the amount of accumulated earnings and profits at the beginning of the taxable year. The words "which previously at any time *were included*" clearly imply an option or election on the part of someone. If there had been any intention that the deduction should be made in every case where the principles of the Sansome case might be applicable the phrase would use the words "were includible" instead of the words "were included." The subsection, therefore, properly may be interpreted as applicable only if the taxpayer elected to include its predecessor's earnings in computing the amount of accumulated earnings and profits included as part of its invested capital for the taxable year.

As shown above, petitioner's interpretation gives meaning to every word in subsection (b)(3). The court's interpretation, however, not only involves deletion of the word "accumulated" from the statute but also involves the assertion that Congress used the words "previously at any time were included in accumulated" as a synonym for the word "became."

It seems obvious that under the court's interpretation the word "accumulated" serves no function in the subsection. That interpretation is to the effect that the statute should be read as saying "the earnings and profits of another corporation which previously at any time were included in earnings and profits" or that it read "earnings and profits of another corporation which *became* earnings and profits." If such earnings and profits became those of a petitioner, they must have become such previously at some time. It is not lightly to be assumed that Congress would have used all

the words "previously at any time were included" as a synonym for the word "became."

The bare language of subsection (b)(3), therefore, indicates that petitioner's interpretation that the words "accumulated earnings and profits" therein refer to accumulated earnings and profits as of the beginning of the taxable year rather than to accumulated earnings and profits at the time of the acquisition of the property by the petitioner, is correct. Obviously, however, this subsection is not to be interpreted in a vacuum.

The language is in a subsection of section 718, subsection (a)(4) of which provides that one of the items added to make up invested capital is "accumulated earnings and profits *as of the beginning of the taxable year.*" The most natural inference as to the "accumulated earnings and profits" to which subsection (b)(3) refers is that it refers to the "accumulated earnings and profits" which were added pursuant to subsection (a)(4).

It is utterly incongruous that in the same section Congress should provide that the accumulated earnings and profits as of a particular date should be added, but that the invested capital should be reduced by an amount included in "accumulated earnings and profits" as of a different date. Obviously subsections (a)(4) and (b)(3) should be read together and being so read it follows that the "accumulated earnings and profits" referred to in subsection (b)(3) are those referred to in subsection (a)(4). There is no justification for saying that the reduction provided in subsection (b)(3) is independent of and unrelated to the specific items to be included in invested capital pursuant to subsection (a) of Section 718.

Nor is there any justification for disregard of the general structure and purpose of the statute in interpreting the language under consideration.

The fundamental elements of equity invested capital are (a) the capital (cash or property) paid in for stock or as a contribution to capital and (b) the accumulated earnings at the beginning of the taxable years. The important dif-

ference between these items is that capital once established by payment to the corporation is not reduced by subsequent losses, whereas accumulated earnings and profits are so reduced, being taken in only at their amount at the beginning of the taxable year. As stated in section 30.718-1 of Regulations 109, approved February 8, 1941:

> "The fact that the money or property paid in has been lost, destroyed, or otherwise disposed of shall not reduce the invested capital, except as such facts are reflected in the earnings and profits as of the beginning of the taxable year."

In drafting the provisions for determination of invested capital Congress was confronted with the question whether a new corporation resulting from a consolidation or other reorganization involving transfers of assets without recognition of gain or loss to the transferor or transferors, should be treated as a new taxpayer having its own invested capital or whether the consolidated corporation should be treated as a mere continuance of its predecessors.

The general principle is that such a corporation is treated for income tax purposes as a new taxpayer separate and distinct from its predecessors. The resulting corporation must file its own return including only its own income irrespective of whether the transfer was made before the expiration of the transferor's taxable year or years. The transferee is not entitled to deduct any net loss of the transferors which would have been allowable if there had been no reorganization. *New Colonial Ice Co.* v. *Helvering*, 292 U. S. 435, 54 S. Ct. 788.

There is no doubt that this same general principle was adopted in the excess profits tax law. The corporation resulting from the reorganization is treated as a new and different taxpayer from the transferors. It must file its own excess profits tax return, reporting its own income and deductions and reflecting its own separate invested capital. The predecessor corporations report only their own income and invested capital and have no right to the benefits of the so-called carry back provisions of section 710(c) of the

Internal Revenue Code, and the new corporation has no right to any carry over of net operating losses of the transferors.

To the general principle of the income tax law that a new corporation transferee in a non-recognition transaction is treated as an entirely new and different taxpayer there is an apparent exception that in certain circumstances the transferee may be treated as a continuance of the transferor for the purpose of determination of the status in the hands of the stockholders of distributions by the transferee. The principle was first laid down in *Commissioner* v. *Sansome*, supra.

The statutory provisions imposing the excess profits tax show that Congress deliberately rejected the so-called continued entity theory for purposes of determination of the invested status of assets paid in for stock in cases of transfers without recognition of gain or loss. As shown above there is no doubt that for excess profits tax purposes the new corporation is treated as a new and different taxpayer.

If Congress had intended to adopt the continuing entity theory for purposes of invested capital, it would have so provided in a few simple words in subsection (a)(2) of section 718. Instead of so providing, subsection (a)(2) recognizes that the entire net assets paid into the taxpayer for stock shall be included in paid in capital of the taxpayer irrespective of whether gain or loss was recognized upon the transfer and without regard to the invested capital status of the assets in the hands of the transferee. This is so because subsection (a)(2) expressly provides for the case of property having a "substituted basis" which is the status of property acquired upon a non-recognition transfer.

Supplement B of the Second Revenue Act of 1940 (see Appendix pg. 27) contains detailed provisions relating to adjustments of the invested capital credit in the case of corporations resulting from non-recognition reorganizations and using the invested capital method of computing the excess profits tax credit. Such supplement is obviously intended by Congress to embrace complete provisions for the adjustment of credits of reorganized corporations. Such

supplement contains no provision indicating or requiring that there should be any reduction in invested capital because of loss of assets paid in as capital of the transferee.

Subsections (a)(7) and (c)(5) of section 718 further evidence the Congressional intent to reject the continuing entity theory for invested capital purposes. These complicated provisions give certain transferees of deficit transferor corporations the benefit of the paid in capital of the transferors. The relief is confined to cases where the transferee acquired substantially all the assets of a single transferor, the stockholders of the transferor received all the stock of the transferee, and the transferor was forthwith dissolved. These provisions would have been entirely unnecessary had Congress adopted the continuing entity theory for invested capital purposes and the fact that such relief was necessary establishes that the statute in its basis structure provides for determination of a new invested capital for every new corporation.

Adoption of the principle that assets acquired for stock in such non-recognition reorganizations should have the status of paid in capital of the transferee recognizes the basic fact that these assets are what the contributors thereof put at the risk of the operations of the taxpayer corporation. This is the standard which Congress adopted for measuring excessive profits.

Thus the language of subsection (b)(3) interpreted in the light of other statutory provisions shows that the "accumulated earnings and profits" referred to in subsection (b)(3) are those as of the beginning of the taxable year, and that, therefore, where there are no such accumulated earnings and profits there should be no reduction on account of predecessor earnings and profits.

CONCLUSION.

It is respectfully submitted that the petition for a writ of certiorari to the Circuit Court of Appeals for the Third Circuit should be granted.

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APPENDIX.

Statutes.

Section 201 of the Second Revenue Act of 1940, 54 Statutes at Large 975, 26 U. S. C. A., amended the Internal Revenue Code by inserting after section 706 thereof a new subchapter E imposing an excess profits tax. One of the new sections so added to the Internal Revenue Code, section 718, reads as follows:

"SEC. 718. EQUITY INVESTED CAPITAL.

"(a) Definition.—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

"(1) Money paid in.—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

"(2) Property paid in.—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined in the same manner as if the property were still held at the beginning of such taxable year. If such unadjusted basis is a substitute basis it shall be adjusted, with respect to the period before the property was paid in, in the manner provided in section 113 (b)(2);

"(3) Distributions in stock.—Distributions in stock—

"(A) Made prior to such taxable year to the extent to which they are considered distributions of earnings and profits; and

"(B) Previously made during such taxable year to the extent to which they are contsidered distributions of earnings and profits other than earnings and profits of such taxable year;

"(4) Earnings and profits at beginning of year.—The accumulated earnings and profits as of the beginning of such taxable year; and

"(5) Increase on account of gain on tax-free liquidation.—In the case of the previous receipt of property (other than property described in the last sentence of section 113(a)(15)) by the taxpayer in complete liquidation of another corporation under section 112(b)(6), or the corresponding provision of a prior revenue law, an amount with respect to each such liquidation equal to the amount by which the aggregate of the amount of the moneys so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received, exceeds the sum of:

"(A) The aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

"(B) The aggregate of the liabilities of such other corporation assumed by the taxpayer in connection with the receipt of such property of the liabilities (not assumed by the taxpayer) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received) given by the taxpayer for such property so received.

"(b) Reduction in Equity Invested Capital.—The amount by which the equity invested capital for any day shall be reduced as provided in subsection (a) shall be the sum of the following amounts—

"(1) Distributions in previous years.—Distributions made prior to such taxable year which were not out of accumulated earnings and profits;

"(2) Distributions during the year.—Distributions previously made during such taxable year which are not out of the earnings and profits of such taxable year;

"(3) Earnings and profits of another corporation.—The earnings and profits of another corporation which previously at any time were included in accumulated earnings and profits by reason of a transaction described in section 112(b) to (e), both inclusive, or in the corresponding provision of a prior revenue law, or by reason of the transfer by such other corporation to the taxpayer of property the basis of which in the hands of the taxpayer is or was determined with reference to its basis in the hands of such other corporation, or would have been so determined if the property had been other than money; and

"(4) Reduction on account of loss or tax-free liquidation.—In the case of the previous receipt of property (other than property described in the last sentence of section 113(a)(15)) by the taxpayer in complete liquidation of another corporation under section 112(b)(6), or the corresponding provision of a prior revenue law, an amount, with respect to each such liquidation, equal to the amount by which the sum of—

"(A) The aggregate of the adjusted basis of each share of stock with respect to which such property was received; such adjusted basis of each share to be determined immediately prior to the receipt of any property in such liquidation with respect to such share, and

"(B) The aggregate of the liabilities of such other corporation assumed by the taxpayer in connection with the receipt of such property, of the liabilities (not assumed by the taxpayer) to which such property so received was subject, and of any other consideration (other than the stock with respect to which such property was received), given by the taxpayer for such property so received,

exceeds the aggregate of the amount of the money so received and of the adjusted basis, at the time of receipt, of all property (other than money) so received. The amount of the reduction under this paragraph shall not exceed the accumulated earnings and profits as of the beginning of such taxable year.

"(c) Rules for Application of Subsections (a) and (b).—For the purposes of subsections (a) and (b)—

"(1) Distributions to shareholders.—The term 'distribution' means a distribution by a corporation to its shareholders, and the term 'distribution in stock' means a distribution by a corporation in its stock or rights to acquire its stock. To the extent that a distribution in stock is not considered a distribution of earnings and profits it shall not be considered a distribution. A distribution in stock shall not be regarded as money or property paid in for stock, or as paid-in surplus, or a contribution to capital.

"(2) Distributions in first sixty days of taxable year.—In the application of such subsections to any taxable year beginning after December 31, 1940, so much of the distributions (taken in the order of time) made during the first sixty days thereof as does not exceed the accumulated earnings and profits as of the beginning thereof (computed without regard to this paragraph) shall be considered to have been made on the last day of the preceding taxable year.

"(3) Computation of earnings and profits of tax able year.—For the purposes of subsections (a) (3) (B) and (b) (2) in determining whether a distribution is out of the earnings and profits of any taxable year, such earnings and profits shall be computed as of the close of such taxable year without diminution by reason of any distribution made during such taxable year or by reason of the tax under this subchapter for such year and the determination shall be made without regard to the amount of earnings and profits at the time the distribution was made.

"(4) Stock in case of merger or consolidation.—If a corporation owns stock in another corporation, and—

"(A) such corporations are merged or consolidated in a statutory merger or consolidation, or

"(B) such corporations are parties to a transaction which results in the elimination of such stock in a manner similar to that resulting from a statu-

tory merger or consolidation, then such stock shall not be considered as property paid in for stock of or as paid-in surplus of, or as a contribution to capital of, the corporation resulting from the transaction referred to in subparagraph (A) or (B).

"(d) For special rules effecting computation of property paid in for stock in connection with certain exchanges and liquidations, see section 751(a).

"(e) For determination of equity invested capital in special cases, see section 723."

Such subchapter E also included in Supplement B a new section of the Internal Revenue Code, section 751, subsection (a) of which read as follows:

"(a) Property Paid In for Stock.—In the application of section 718(a) to a transferee upon an exchange in determining the amount paid in for stock of the transferee, or as paid in surplus or as a contribution to capital of the transferee, in connection with such exchange, only an amount shall be deemed to have been so paid in equal to the excess of the basis in the hands of the transferee of the property of the transferor received by the transferee upon the exchange over the sum of—

"(1) Any liability of the transferor assumed upon such exchange and any liability subject to which the property was received upon such exchange, plus

"(2) The aggregate of the amount of money and the fair market value of any other property transferred to the transferor not permitted to be received by such transferor without the recognition of gain."

Section 203 of the Revenue Act of 1941, 55 Statutes at Large 702, 26 U. S. C. A., amended the above section 718 retroactively by adding a new subsection (a) (6) dealing with new capital, which is not quoted as it has no direct application here.

Section 219 of the Revenue Act of 1942, 56 Statutes at Large 911, 26 U. S. C. A., retroactively amended the above quoted section 718 as follows:

"(a) Addition to Equity Invested Capital of Transferee.—Section 718(a) is amended by inserting at the end thereof the following new paragraph:

"'(7) Deficit in earnings and profits of another corporation.—In the case of a transferee, as defined in subsection (c) (5), an amount, determined under such paragraph, equal to the portion of the deficit in earnings and profits of a transferor attributable to property received previously to such day.'

"(b) Reduction of Equity Invested Capital of Transferor.—Section 718(b) is amended by inserting at the end thereof the following new paragraph:

"'(5) Deficit in earnings and profits transferred to another corporation.—In the case of a transferor, as defined in subsection (c) (5), an amount, determined under such paragraph, equal to the portion of the deficit in earnings and profits of the transferor attributable to property transferred previously to such day."

"(c) Earnings and Profits of Transferor and Transferee.—Section 718(c) (relating to rules for determining invested capital) is amended by inserting at the end thereof the following new paragraph:

"'(5) Deficit in Earnings and profits.—Earnings and profits of transferor and transferee.—If a corporation (hereinafter called "transferor") transfers substantially all its property to another corporation formed to acquire such property (hereinafter called "transferee"), if—

"'(A) the sole consideration for the transfer of such property is the transfer to the transferor or its shareholders of all the stock of all classes (except qualifying shares) of the transferee. (In determining whether the transfer is solely for stock, the assumption by the transferee of a liability of the transferor or the fact that the property acquired is subject to a liability shall be disregarded);

"'(B) the basis of the property, in the hands of the transferee, for the purposes of this subsection, is determined by reference to the basis of the property in the hands of the transferor;

"'(C) the transferor is forthwith completely liquidated in pursuance of the plan under which the acquisition of the property is made; and

"'(D) immediately after the liquidation the shareholders of the transferor own all such stock; for the purposes of this subchapter, in computing the equity invested capital for any day after the date of the acquisition of the property, the earnings and profits or deficit in earnings and profits of the transferee and the transferor shall be computed as if, immediately before the beginning of the taxable year in which such transfer occurs, the transferee had been in existence and sustained a recognized loss, and the transferor had realized a recognized gain, equal to the portion of the deficit in earnings and profits of the transferor attributable to such property.'

"(d) Taxable Years to Which Amendments Applicable.—The amendments made by this section shall be applicable to taxable years beginning after December 31, 1939."

Regulations.

Regulations 109, Section 30.718-5 originally provided in part as follows:

"If the earnings and profits of another corporation previously at any time were included in the accumulated earnings and profits of the taxpayer by reason of a transaction referred to in Section 718(b)(3), the amount of such earnings and profits shall be deducted in determining the equity invested capital. The provisions of this paragraph may be illustrated by the following example:

"Example: The Y Corporation prior to July 1, 1939, had capital stock outstanding of $20,000 and accumulated earnings and profits of $5,000. The X Corporation was organized on July 1 to take over all the assets of the Y. Corporation in exchange for all of its stock. Stock in the amount of $25,000 was issued by the X Corporation in exchange for all the assets of the Y Corporation which had an adjusted basis to the Y Corporation of $25,000. Since the property of the Y Corpora-

tion in the amount of $25,000 is a part of the invested capital of the X Corporation as property paid in for stock *and in addition the accumulated earnings and profits of the Y Corporation amounting to $5,000 are considered part of the accumulated earnings and profits of the X Corporation,*[1] *the invested capital of the corporation for the taxable year must be reduced by $5,000, the amount of the earnings and profits of the Y Corporation, as provided by section 718(b)(3).*" (Italics supplied)

Section 30.718-6 of Regulations 109, as added by Treasury Decision 5299, October 1, 1943, reads as follows:

"REG. 109, SEC. 30.718-6. Determination of daily equity invested capital—Reduction by earnings and profits of another corporation.—Section 718(b)(3) provides for the elimination of the duplication which occurs in the computation of the equity invested capital of the taxpayer following a transaction of the character referred to therein, as a result of which the earnings and profits of another corporation became the earnings and profits of the taxpayer. The earnings and profits of such other corporation having been included at the time of the transaction in the earnings and profits of the taxpayer, they remain continuously thereafter a part of such earnings and profits account for the purpose of computing for any day after such transaction the earnings and profits, the accumulated earnings and profits at the beginning of the taxable year, and the earnings and profits of the taxable year. In addition, however, the amount of such included earnings and profits is also brought into computation of equity invested capital of the taxpayer under provisions of section 718 other than section 718(a)(4) relating to accumulated earnings and profits as of the beginning of the taxable year. Thus if the transaction is a reorganization to which section 113(a)(7) is applicable, and in which the taxpayer receives all the assets of another corporation in exchange solely for its own stock, such amount has already been taken into account in property paid in for stock under section 718(a)(2); or if the transaction is an inter-

[1] Commissioner v. Sansome (60 Fed. (2d), 931).

corporate liquidation of another corporation involving a distribution with respect to stock of such other corporation held by the taxpayer with a basis determined under section 761 to be a basis other than cost, such amount has already been taken into account in the computation of equity invested capital of the taxpayer, as adjusted under section 761(d)(2).

"To preclude this duplicate inclusion of the earnings and profits of another corporation in the invested capital of the taxpayer, section 718(b)(3) provides, as a step in the computation of equity invested capital, for the reduction of equity invested capital otherwise computed by the amount of earnings and profits of another corporation previously at any time included in the earnings and profits of the taxpayer. This adjustment is to be made in the computation of equity invested capital for each day after the day of such transaction, regardless of whether the earnings and profits absorbed were produced during the taxable year of the taxpayer in which such transaction occurred or in a prior taxable year, and regardless of the condition of the earnings and profits account of the taxpayer immediately prior to or at any time subsequent to the date of such transaction."